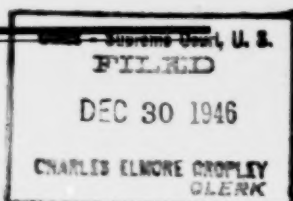


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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946.

No. 831

**JOSEPH B. FLEMING and AARON COLNON, Trustees of the
Estate of The Chicago, Rock Island and Pacific Railway Com-
pany, a Corporation,**

Petitioners,

VS.

OKLAHOMA TAX COMMISSION,

Respondents.

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE TENTH CIRCUIT AND BRIEF IN SUP-
PORT THEREOF.**

✓
✓
✓
✓
W. F. PETER,
W. V. HODGES,
J. L. GOREE,
JAMES E. GRIGSBY,
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Fleming and Aaron Colnon, Trustees
of the Estate of The Chicago, Rock
Island and Pacific Railway Company.

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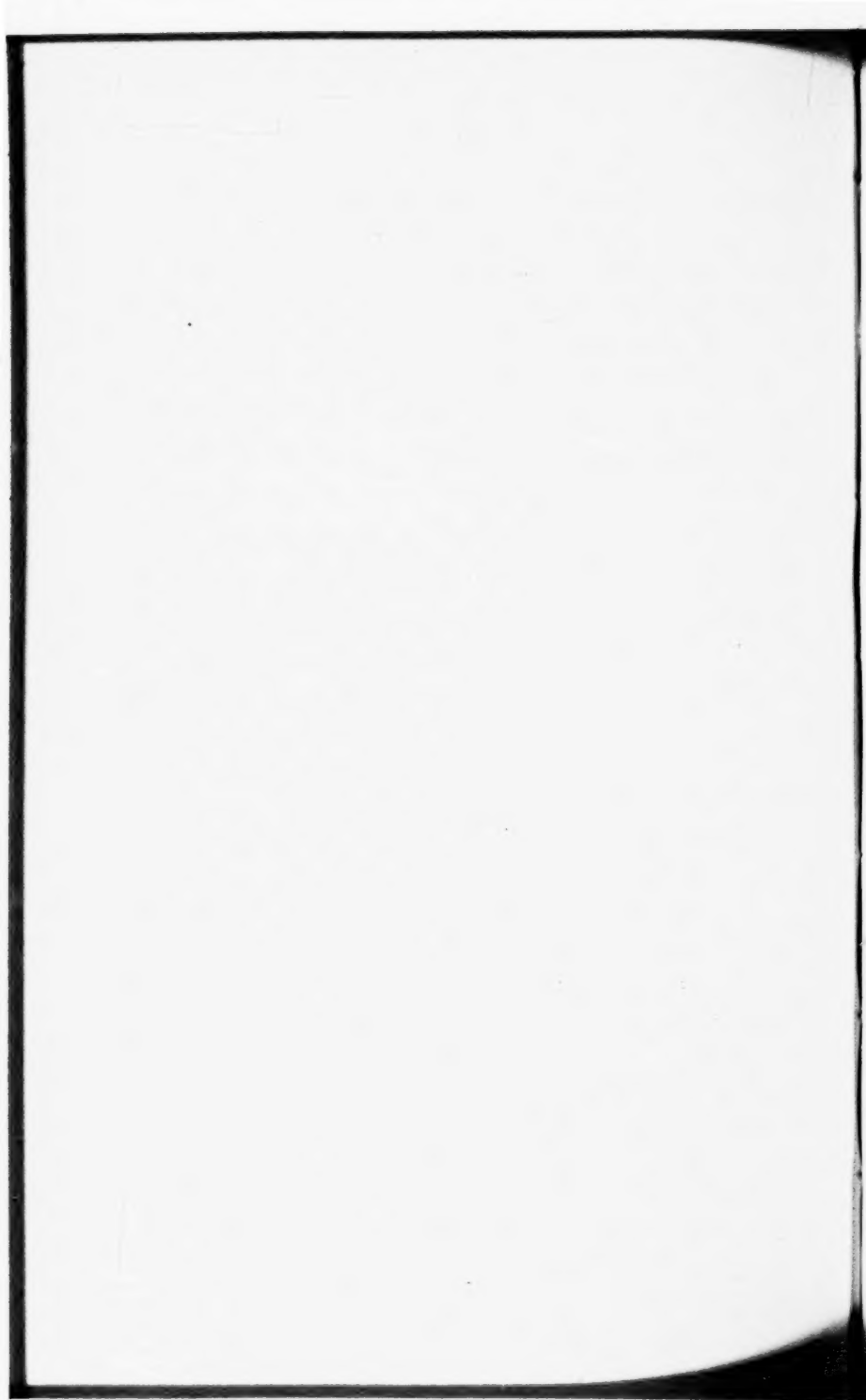
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IN THE
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OCTOBER TERM, 1946.

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**JOSEPH B. FLEMING and AARON COLNON, Trustees of the
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OKLAHOMA TAX COMMISSION,

Respondents.

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE TENTH CIRCUIT.**

*To the Honorable the Chief Justice and the Associate
Justices of the Supreme Court of the United States:*

Your petitioners respectfully show:

Summary Statement of the Matter Involved.

This is an action brought by Joseph B. Fleming and Aaron Colnon, Trustees in bankruptcy of The Chicago, Rock Island and Pacific Railway Company, a corporation, against the Oklahoma Tax Commission to recover additional state income taxes paid under protest. The trustees are non-residents of Oklahoma; the company is a foreign corporation.

The action was commenced by the filing in the United States District Court for the Western District of Oklahoma of a complaint in which the petitioners prayed judgment for \$91,843.20 with interest (R. 1). The case was tried without a jury and after the filing of findings of fact and conclusions of law (R. 164-173) judgment was rendered against the petitioners (R. 177), who thereupon appealed to the Circuit Court of Appeals for the Tenth Circuit (R. 178). There the District Court's judgment was affirmed on October 30, 1946 (R. 259).

The railroad (as we shall sometimes for convenience designate the petitioning trustees in bankruptcy) duly filed its income tax returns for each of the years 1941 and 1942 (Exhibits 7 and 8, R. 85 and 105, respectively, to the stipulation of facts filed by the parties hereto which begins on page 17 of the record.*). The 1941 return showed no net income earned in Oklahoma (R. 89). The 1942 return showed income attributable to Oklahoma of \$707,092.72 (R. 109) and the tax thereon of \$42,225.56 was paid. On these returns the railroad segregated Oklahoma net income, as such, as opposed to allocating to the state a fractional part of its entire net income.

The tax commission professed to audit these returns. However, it entirely disregarded them and the principle upon which they were prepared and used a different method of computation, arriving at "Taxable Net Income Adjusted" of \$376,509.61 for 1941 (Exhibit 12, R. 136) and \$1,844,791.94 for 1942 (Exhibit 11, R. 133). After

* Exhibits 1 to 22, inclusive, were admitted pursuant to this stipulation of facts. Hereinafter in citing these exhibits we shall omit the notation that they are attached to and identified by the stipulation. Exhibit 22, being the Accounting Classifications of the Interstate Commerce Commission, is bound as Volume II of the transcript of the record; consequently all page references to the record are to Volume I thereof.

the railroad had filed its protest to these additional assessments and the additional taxes levied thereon (Exhibit 17, R. 148), the commission amended the assessments so as to be \$320,448.68 for 1941 (Exhibit 14, R. 142) and \$1,789,421.82 for 1942 (Exhibit 13, R. 141). These are the assessments in controversy. The taxes on these additional assessments, plus interest, in the amounts of \$21,870.62 for 1941 and \$69,972.58 for 1942 were paid under protest and this action was brought to recover them pursuant to the remedy provided by Section 910, Title 68, Oklahoma Statutes, 1941.*

The tax commission computed Oklahoma taxable net income by applying to the railroad's entire net income the arithmetical average of three factors; namely, the percentages which the Oklahoma operating revenues, operating expenses and investment-fixed assets bore to the corresponding items of the entire system (see "Basis of Prorating Income to Oklahoma," R. 139). This formula is provided by subsection (g) of Section 878, Title 68,

* After the original complaint was filed but before it was answered the commission assessed further additional income taxes and interest in the sum of \$3,885.02 for 1941 (Exhibit 15, R. 143) and \$3,637.79 for 1942 (Exhibit 16, R. 145); and in its answer it alleged that the taxes to recover which the railroad had filed suit were computed and assessed pursuant to what the commission thought to be an understanding between agents of the railroad and agents of the tax commission and that upon learning from the complaint that there was no such understanding the tax commission had made a recomputation which resulted in the amounts just mentioned. These further deficiency assessments were paid and the railroad filed a supplemental complaint for their recovery (R. 9). However, this aspect of the controversy was settled during the trial and the supplemental complaint was dismissed (R. 177).

Oklahoma Statutes, 1941.* There is no dispute as to the mathematical accuracy of the commission's calculations under this formula. Petitioners' contentions are simply that subsection (g) is not applicable by the terms of the statute itself to the entire net income of the railroad; and that, if applicable, the statute is unconstitutional under the Due Process Clause of the Fourteenth Amendment to the Federal Constitution.

Subsection (d) of Section 878 provides that taxable net income, whether it be derived from transactions performed or property located wholly within Oklahoma or partly within Oklahoma, shall be determined in accordance with the succeeding subsections of Section 878.

Subsection (e) provides in part that income from real and tangible personal property shall be allocated in accordance with the situs of such property and that allowable deductions attributable to such income shall be allocated on the same basis.

Subsection (f) provides that "net income or (loss) from a business activity of substantial separateness and completeness, such as might be maintained as an independent business (however convenient and profitable it might be if operated conjointly with a related activity) and capable of producing a profit in and of itself, shall be separately allocated to the State in which such activity is conducted."

Subsection (g), before prescribing the formula used by the tax commission, provides that such formula shall apply only to the net income which remains after the separate allocations in subsections (e) and (f); and that such income that remains "shall be only that which is derived from the conduct in more than one state of a single business enterprise (commonly called unitary

* Text of statute appears in appendix hereto.

business), all the factors of which enterprise are essential to the realization of an ultimate gain derived from the enterprise as a whole, and not from its component parts which are too closely connected and necessary to each other to justify division or separate allocation in subsection (f) *supra*."

Petitioners from the outset of these proceedings have contended, and now contend, with respect to the above cited statutes that:

I. Subsection (g) is not applicable to the railroad's entire net income for the following reasons, each of which is sufficient in itself:

(A) The railroad's entire net income being derived from real and tangible personal property is allocable under (e) according to the situs of such property; and, in any view of (e), many parts of that income are so allocable.

(B) Regardless of the applicability of (e) many parts of the railroad's net income are derived from activities which might be maintained as independent businesses within the meaning of (f).

(C) The railroad's business is not "unitary" within the meaning of (g) and, hence, the formula of (g) is inapplicable to the railroad's entire net income, whether or not all or any part of it is susceptible of separate allocation under (e) or (f).

II. Subsection (g), if applicable by the terms of the statute, is violative of the Due Process Clause of the Fourteenth Amendment to the Federal Constitution in that the formula prescribed therein operates in such a way as to reach income of the railroad not earned in Oklahoma.

The questions presented by the above contentions were decided by the District Court against the petitioners. (Conclusions of Law A, B, C, and D; R. 169-173). On appeal the Circuit Court of Appeals did likewise.

As to the first question, the Circuit Court of Appeals held that the railroad's business and every part of it constituted a unitary business (R. 255), and that (g) applied to the entire net income therefrom (R. 256); and that, therefore, nothing remained separately to allocate under (e) or (f) (R. 256).

As to the second question, the Circuit Court of Appeals held that the formula of (g) operated in such a way as to reach only a fair share and proper proportion of the railroad's entire net income; and that, hence, the subsection was constitutional in its application to the railroad's entire net income (R. 257).

The decisions on these questions materially affected the determination of the appeal.

Statutes Involved.

The pertinent provisions of Sections 876 and 878, Title 68, Oklahoma Statutes, 1941, are reproduced as an appendix, *infra*, page 33.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered October 30, 1946 (R. 259). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. Section 347).

Questions Presented.

Of State Law.

I. Whether subsection (g), Section 878 Title 68, Oklahoma Statutes, 1941, which contains the formula used by the Oklahoma Tax Commission in determining the railroad's Oklahoma net taxable income, is applicable to the railroad's entire net income?

(A) Is the railroad's net income, or any part of it, derived from real or tangible personal property so as to be susceptible of separate allocation under subsection (e) in accordance with the situs of such property?

(B) Is any part of the railroad's business a "business activity of substantial separateness and completeness such as might be maintained as an independent business (however convenient and profitable it might be if operated conjointly with a related activity) and capable of producing a profit in and of itself" so that the net income therefrom may be separately allocated under subsection (f)?

(C) Is every factor of the railroad's business "essential to the realization of an ultimate gain from the enterprise as a whole" so as to subject its entire net income to the formula of subsection (g)?

Of Federal Law.

II. Whether the formula of subsection (g) applied to the entire net income of the railroad operates in such a way as to reach income earned outside of Oklahoma so as to offend the Due Process Clause of the Fourteenth Amendment to the Federal Constitution?

Reasons Relied On for the Issuance of the Writ.

As to the State Question.

1. The Circuit Court of Appeals has decided an important question of local law in a way probably in con-

fict with an applicable state statute, in that the Court held that the petitioners' business was "unitary" on the authority of federal decisions, in the face of an explicit definition of a unitary business contained in the Oklahoma statutes. Subsection (g) Sect. 878, Title 68, O. S. 1941 defines a unitary business as "a single business enterprise, all the factors of which enterprise are essential to the realization of an ultimate gain derived from the enterprise as a whole * * *." The federal decisions followed by the Circuit Court of Appeals define it as something else, (according to that Court's construction of them). The Court ignored the definition of the state statute and said (R. 255):

"What is a unitary business for the purpose of allocating taxable value has been clearly settled by the decisions of the Supreme Court over a long period of time. Its characteristics are restated in *Butler Bros. v. McColgan*, 315 U. S. 501, where Justice Douglas said:

'At least since *Adams Express Company v. Ohio*, 165 U. S. 194, this court has recognized that unity of use and management of a business which is scattered through several states may be construed when a state attempts to impose a tax on an apportionment basis.'

The test was laid down to be whether all factors are essential to the ultimate realization of gain."

The very nature of petitioner's business, said the Court, brought it "especially within *this* concept of a unitary business." (Emphasis ours.)

2. The Circuit Court of Appeals has decided an important question of local law in a way probably in conflict with an applicable decision of the Supreme Court of Oklahoma, namely *Magnolia Petroleum Company v. Oklahoma Tax Commission*, 190 Okla. 172, 121 Pac. 2d 1008, which holds that in determining the income tax of a cor-

poration engaged in an interstate business direct allocation is entitled to first consideration, and that formulas for allocating to Oklahoma a fractional part of entire net income have no place if the accounts of the taxpayer substantially reflect the net income derived from business transacted and property located within the state.

As to Federal Question.

3. The Circuit Court of Appeals has decided a federal question in a way that is probably in conflict with applicable decisions of this Court, namely *Hans Rees' Sons, Incorporated v. North Carolina*, 283 U. S. 123; *Shaffer v. Carter*, 252 U. S. 37; *Alpha Portland Cement Company v. Massachusetts*, 268 U. S. 203; *International Paper Company v. Massachusetts*, 246 U. S. 135; *Connecticut General Life Insurance Company v. Johnson, State Treasurer*, 303 U. S. 77, and *James, State Tax Commissioner v. Dravo Contracting Company* 302 U. S. 134, which cases hold that a method of taxation which operates so as to reach income, objects or events not having their situs within the boundaries of the state levying the tax is violative of the Due Process Clause of the Fourteenth Amendment to the Federal Constitution.

4. The Circuit Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court; that is, whether a state may constitutionally levy a tax on a fractional part of the entire net income of a railroad operating partly within the state, such income being derived from *transportation services* having, necessarily, a definitely ascertainable situs and the net income therefrom being susceptible of segregation with reasonable certainty. In view of the facts that many states have enacted, and others may enact, laws levying taxes on incomes of non-resident interstate businesses and that there are a large number of

railroads operating within those states, it is important that this question be finally settled by this Court.

Wherefore, your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of this Honorable Court directed to the Circuit Court of Appeals for the Tenth Circuit commanding that Court to certify and send to this Court for its review and determination, on a date certain to be therein named, a full and complete transcript of the record and the proceedings in the case numbered and entitled on its docket No. 3264, "Joseph B. Fleming and Aaron Colnon, Trustees of the estate of The Chicago, Rock Island and Pacific Railway Company, a corporation, appellants v. Oklahoma Tax Commission, appellee," to the end that said case be reviewed and determined by this Court, and that the judgment herein of said Circuit Court of Appeals be reversed; and that your petitioners may have such other and further relief in the premises as to this Court may seem proper.

Joseph B. Fleming and Aaron Colnon, Trustees of the Estate of The Chicago, Rock Island and Pacific Railway Company, a corporation.

By: W. F. PETER,

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Oklahoma City, Oklahoma.

Dated this ^{28th} day of December, 1946, at Chicago, Illinois.

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946.

No.

JOSEPH B. FLEMING and AARON COLNON, Trustees of the
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pany, a Corporation,

Petitioners,

vs.

OKLAHOMA TAX COMMISSION,

Respondents.

BRIEF IN SUPPORT OF PETITION FOR
WRIT OF CERTIORARI.

Opinions Below.

The Judge of the United States District Court for the Western District of Oklahoma did not file any opinion except that contained in his conclusions of law and notes thereto, which were not reported. They were filed on July 24, 1945 and appear in the record at pages 169-173.

The opinion of the Circuit Court of Appeals for the Tenth Circuit was rendered on October 30, 1946 and appears in the record at pages 251-259. It has not yet been reported.

Jurisdiction.

A statement of the jurisdiction is given in the petition (p. 6) and to avoid duplication is not repeated here.

Statement of the Case.

The petitioners' railroad is a typical large American railway system. It has lines in fourteen states, including Oklahoma, and its principal source of income is revenues from the transportation of freight and passengers. Most of these revenues for the years 1941 and 1942 were received in payment for services performed in their entirety outside of Oklahoma.

As required by law, the railroad's accounts are kept in accordance with rules promulgated by the Interstate Commerce Commission (Exhibit 22, which is bound in its entirety as Vol. II of the record). We are here concerned with the Operating Revenue (Exhibit 22, pages 59-72), Operating Expense (Exhibit 22, pages 73-160), and Income (Exhibit 22, pages 163-221) accounts. A mere glance through Exhibit 22 will suffice to show the completeness of these classifications and the minuteness with which they are divided and sub-divided, there being some 140 primary accounts which pertain to the operating revenues and expenses of this railroad.

The Interstate Commerce Commission's accounting regulations contain the general instruction that "the carriers' records shall be kept with sufficient particularity to show fully the facts pertaining to all entries made in the accounts provided herein for railway operations. Where the full information is not recorded in the general books, the entries therein should be supported by other records in which the full details shall be shown." (Exhibit 22, page 53). These "full details" come from the

initial or underlying records made more or less contemporaneously with the transactions recorded. Passenger revenues are ascertained from the ticket stubs; freight revenues from the waybills of which there is one for each shipment of freight whether carload or single package. The ticket stub and the waybill also show the point of origin and point of destination so that the place where the service is performed can be ascertained. Likewise there is a record of every disbursement for operating expense; payrolls for wages, and storekeeper's records for materials used for maintenance. For example, track maintenance work is performed by section gangs, each assigned to work within particular limits. The time books for each gang are kept by the section boss. These are turned in periodically to the accounting department and the data are drawn therefrom showing the expenses incurred for labor performed, material used, and the locality of the work (R. 194-200).

By ascertaining a state's portion of each primary account, the railroad is able to segregate with reasonable accuracy net income actually earned in that state, and there is no occasion to resort to formulas which more or less arbitrarily assign to the state a fractional part of the net income earned everywhere. The bases upon which revenues and expenses recorded under the several primary accounts are apportioned to states are contained in Exhibit 5 (R. 63-71) and Exhibit 6 (R. 73-83), respectively. A due regard for the time of this Court forbids more than the most cursory description of them.

In general it may be said that all revenues from intrastate traffic are attributed to the state in which the movement occurred and the revenues from interstate traffic to the states within which parts of the movement occurred on a prorata mileage basis. Revenues from station privileges, checking of parcels, stockyards services,

rents of buildings and other property, and other revenues from similar sources are credited to the states in which are located the properties giving rise to the revenues. (Exhibit 5, Accounts 133, R. 64; 134, R. 65; 140, R. 66; 142, R. 66, respectively).

Each primary expense account, as with the revenue accounts, is apportioned to states in accordance with factors logically related to the subject matter of the account. Expenses recorded under many of the accounts are incurred wholly within a state and are charged directly to that state. Thus the cost of ties (Exhibit 6, Account 212, R. 73), rails (Account 214, R. 73) and other track material (Account 216, R. 73) used in the repair of a track, and the cost of labor in connection therewith, are charged to the state in which the track is located. The same is true as to the cost of repairing and maintaining buildings and other structures such as roadway buildings (Account 229, R. 73), stations (Account 227, R. 73), and other miscellaneous structures (Account 265, R. 74). Expenses which do not permit of such direct allocation are apportioned to states by methods dictated by the nature of the expense, the basic factor of which is, in general, mileage.

As required by state law the railroad reported to the Oklahoma Corporation Commission for each of the years 1941 and 1942 "Railway Operating Revenues Earned Within the State", (Exhibits 3 and 3A, R. 47, 49), and "Railway Operating Expenses Within the State", (Exhibits 4 and 4A, R. 51-55, 57-61), derived by the use of these methods. Neither the appropriateness of these formulas nor the accuracy with which they were applied in these reports was questioned, and presumably the corporation commission used the results thereby obtained, where relevant, in all of its statutory functions. Furthermore, Oklahoma revenues and Oklahoma expenses thus

computed were used by the tax commission as the antecedent terms in the revenue and expense ratios of the formula by which it determined Oklahoma net taxable income.

Specification of Errors.

The Circuit Court of Appeals erred:

1. In holding that no part of the petitioners' net income was susceptible of separate allocation under subsection (e) Section 878, Title 68, O. S. 1941 according to the situs of the property producing such income.
2. In holding that no part of the railroad's net income was produced by a business activity of substantial separateness and completeness such as might be maintained as an independent business and therefore susceptible of a separate allocation as provided in subsection (f).
3. In holding that the railroad's entire system was a unitary business and that therefore its entire net income was subject to the formula provided by subsection (g), to the exclusion of any separate allocations under (e) and (f).
4. In holding that subsection (g) as applied to the entire net income of the railroad did not violate the Due Process Clause of the Fourteenth Amendment to the Federal Constitution by allocating to Oklahoma income earned outside the state.

Summary of Argument.

I.

Subsections (e), (f) and (g) of Section 878, Title 68, Oklahoma Statutes, 1941, are related and articulated parts of a unified plan for determining Oklahoma net taxable income of all businesses conducted wholly or partly within the state. Under that plan all of the taxpayer's income which is derived from real or tangible personal property, wherever such property may be located and whether or not the taxpayer's business may be labeled unitary, is to be separately allocated in accordance with the situs of such property and thereby removed from the operation of the formula of subsection (g).

Likewise the net income from a business activity, wherever conducted, is to be separately allocated and thereby removed from the operation of the formula of (g), if such activity *might* be maintained as an independent business capable of producing *a* profit in and of itself.

Petitioners' income is derived from real and tangible personal properties having a definitely ascertainable situs, and income produced thereby and allowable deductions attributable to such income are susceptible of direct allocation according to (e). In the narrowest view of (e) much of the railroad's income is so allocable. The railroad's activities in each of the states in which it operates might be maintained as an independent business and produce *a* profit; and it is immaterial that that profit would not be as great as it now is.

Subsection (g) is properly applicable only to net income which *remains* after the separate allocations of (e) and (f), *and* which is produced by single enterprise all factors of which are essential to the realization of an ultimate gain. Plainly it was the intention of the legislature that the separate allocations under (e) and (f) were to be entitled to first consideration in order that every suspicion of unconstitutionality might be avoided. *Magnolia Petroleum Company v. Oklahoma Tax Commission*, 190 Okla. 172, 121 Pac. 2d 1008.

The Circuit Court of Appeals held that the formula of (g) applied to the railroad's net income, and every part of it. Inasmuch as parts of that income, in the strictest possible construction of (e) and (f), are susceptible of separate allocations thereunder, the assessment is void and the judgment of the Circuit Court of Appeals should be reversed.

Whether or not petitioners' business may be called "unitary" every one of its factors is not "essential to the realization of an ultimate gain derived from the enterprise as a whole", and therefore the formula of (g) is not applicable to the railroad's entire net income to the exclusion of all separate allocations. The Circuit Court of Appeals held that petitioners' business was unitary and that, therefore, nothing "remained" separately to allocate under (e) or (f). The ruling on this local question was made on the authority of federal law and in disregard of the plain language of the state statute.

II.

The nature of petitioners' business is such that a fractional part of the entire net income derived therefrom cannot be allocated to a state for tax purposes without including therein income earned extra-territorially.

The statutory formula used by the tax commission does not merely provide a *measure* by which the amount of the tax is to be determined. It creates, or delineates, the taxable object itself; and if, in so doing, it includes income earned without Oklahoma, whether one dollar or a million, the assessment is unconstitutional under the Due Process Clause of the Fourteenth Amendment to the Federal Constitution. In any view of the evidence, the method by which the tax commission determined the petitioners' Oklahoma net taxable income resulted in a tax on a fractional part of many items of income not earned in Oklahoma and to the earning of which the railroad's Oklahoma properties and transactions contributed nothing; and, this being so, there was no occasion for the Circuit Court of Appeals to consider whether or not the statutory formula succeeded in reaching only "a fair share and proper proportion" of the railroad's entire net income.

ARGUMENT.

I.

Subsection (g) is not applicable to the entire net income of the railroad because: (A) the various parts thereof are separately allocable under subsection (e) according to situs; (B) parts of said income are allocable under subsection (f) being derived from activities which might be maintained as separate businesses; and (C) the railroad's business is not "unitary" as such term is defined in subsection (g).

This point deals with the proper construction of an Oklahoma statute and, hence, presents a question of local law only.

Over the petitioners' protest the tax commission subjected their entire net income to the formula prescribed by subsection (g). If the smallest part of that income is not subject to (g) then the assessment is unlawful. The petitioners insist that they have in their returns segregated with reasonable certainty Oklahoma net income in a manner provided for in (e). If that be so, then (g) was improperly applied and that is an end to the case. If the net income from any part of the railroad's business in or out of Oklahoma might be separately allocated under (f) there is likewise an end to the case. However, whether (e) applies to petitioners' net income or parts thereof, and whether (f) applies to petitioners' net income or parts thereof are not ultimate issues. If (g) is not applicable to some part of petitioner's income for any reason, then it is immaterial that no provision

is made for a tax on that part. If that be so, the deficiency is in the Oklahoma law not in petitioners' case.

However, we believe that Section 878 provides a unified plan for dealing with the entire net income of a taxpayer conducting a business wholly or partly within Oklahoma, and that (e), (f), and (g) are related and articulated parts of that plan.

Subsection (d) says that the entire net income of the taxpayer, wherever earned, shall be allocated in accordance with subsections (e), (f), (g) and, in some instances, (h). Subsection (g) plainly indicates that the income referred to in (d) shall first be subjected to (e) and (f) and that the formula prescribed shall be applied only to the "net income remaining." It is plain, therefore, "that direct allocation is entitled to first consideration" and that situational allocations of income and allowable deductions are to be made to the full extent that the facts and circumstances of the taxpayer's transactions permit. *Magnolia Petroleum Company v. Oklahoma Tax Commission*, 190 Okl. 172, 121 Pac. (2d) 1008. The Circuit Court of Appeals gave its "last consideration" to such direct allocations.

(A) Subsection (e) is applicable.

That part of petitioners' railroad which has its situs in Oklahoma produces income. Some of that income is produced from transactions performed wholly within the state; some from transactions performed only partly within the state; but the language of the statute makes no distinction between the two. That a shipment from Oklahoma City to Kansas City, Kansas, for example, is interstate does not affect the fact that the tracks between Oklahoma City and the state line have their *situs*

in Oklahoma, or the fact that the railroad derives income from transporting the shipment over those tracks. Rents of buildings and other property, and income from similar sources, come within the purview of (e) in the narrowest view of the subsection.

It is to be noted in this connection that the income with which (e) deals is to be separately allocated according to situs, whatever that situs may be. (The tax commission construed (e) to cover only income from real and tangible personal property in *Oklahoma* and no net income from real or tangible personal property outside of *Oklahoma* was to be separately allocated and removed from the operation of the formula of (g) even though (e) fit such income like a glove.)

(B) Subsection (f) is applicable.

Petitioners' lines in *Oklahoma* "might be maintained as an independent business." This would seem to be self-evident in the light of the fact that the railroad system of this country, a physical unity, is operated by countless different companies, each one of which maintains its segment of the entire system "as an independent business."

It is here to be noted that the net income with which (f) deals is to be allocated "to the State" in which is conducted the business activity producing it. (The tax commission construed the subsection as applying only to business activities conducted entirely within *Oklahoma* and, hence, the income therefrom was not to be removed from the operation of the formula of (g) if the activity was conducted elsewhere.)

Many of the railroad's activities outside of *Oklahoma* fit the requirements of (f). For example, petitioners' line

of railway between Chicago and Denver is certainly independent of its lines in Oklahoma. The latter can be sold and conveyed without affecting the Chicago-Denver traffic in the slightest; and *vice versa*. Likewise petitioners' several lines between the Twin Cities and Kansas City, and St. Louis and Kansas City, and Memphis and Little Rock are all independent of the lines in Oklahoma. Each carries freight and passenger traffic in great volume and none of it touches Oklahoma or makes use of petitioners' property therein. (Exhibits 19, R. 157; 20, R. 159; 21, R. 161.)

The Circuit Court of Appeals said (R. 255):

"It may be true, as urged by the Railroad, that the Chicago to Denver branch could be operated profitably by itself and that the income realized from its operation can be ascertained. It does not, however, follow that it could be operated *as profitably* by itself or that its income would be *as great as it is* as a part of a large railway network in which other parts lessen overhead burdens or funnel business to the system, which ultimately finds its way to this branch. No doubt its connection with the rest of the system brings it business which otherwise might well go elsewhere." (Emphasis ours.)

The Circuit Court of Appeals said this in the face of the express statement in (f) that:

"Net income (or loss) from a business activity of substantial separateness and completeness, such as might be maintained as an independent business (*however convenient and profitable it might be if operated conjointly with a related activity*) and capable of producing a profit in and of itself, shall be separately allocated to the State in which such activity is conducted." (Emphasis ours.)

(C) The Railroad's business is not unitary within the meaning of subsection (g).

This is the keynote to correct interpretations not only of subsection (g) but (e) and (f) as well.

The Circuit Court of Appeals ruled this all-important question on the authority of *Butler Bros. v. McColgan*, 315 U. S. 501 (R. 255). We respectfully submit that what this Honorable Court may conceive to be a "unitary business" is immaterial on this question. It is the intention of the Oklahoma legislature as expressed in its enactments that must control.

Regardless of unity of use and management, or of physical unity of its properties, a business is not unitary for the purpose of the application of the formula of subsection (g):

(1) If it includes a business activity "of substantial separateness and completeness, such as might be maintained as an independent business, etc.", or

(2) If any of its factors are not "essential to the realization of *an* ultimate gain derived from the enterprise as a whole" (emphasis ours), or

(3) If its component parts are not too closely connected and necessary to each other to justify division or separate allocation."

Thus by stating much the same concept in three different ways the Oklahoma legislature has defined "unitary business" so explicitly as to leave little room for construction.

The petitioners' business in its entirety does not come within the Oklahoma legislature's conception of "unitary" for the reasons, among others, hereinabove mentioned under B. A unitary business in the statutory sense is one which, although conducted partly in one place

and partly in another and involving a series of separate transactions, requires each and every one of the transactions for the ultimate purpose of producing a finished product or service. For example, a manufacturer of typewriters may make the parts in one state, assemble them in another, and enamel and otherwise finish the machines in still another. Its profits are realized from the sale of the typewriters; and the manufacture of the parts, their assembly, and the final finishing of the machines are but separate processes towards that end. Manifestly, it would not be "just" separately to allocate all income to the state in which the typewriters were completed and sold, and nothing to those in which the parts were made and assembled.

The railroad's business is materially different; its product is transportation service and its trains manufacture it in its entirety as they go. The traffic over its lines that do not touch Oklahoma, and for the transportation of which the Oklahoma lines are not used, adds nothing to the quality or value of, or revenues from, the transportation services rendered in Oklahoma.

It is to be emphasized that *practical* difficulty—even *practical* impossibility—of separately allocating net income earned by the several component parts of a business does not serve to characterize that business as unitary, (for the simple and sufficient reason that the statute does not make it so). It is an inherent, an *a priori*, impossibility of such allocation that is significant. To use a figure of speech, a true unitary business in the statutory sense is like a vine, with its roots in one state, its trunk in another, and its fruit in still others. The fruit is the *joint* product of all the component parts of the plant and, by very definition, no portion thereof can justly be credited to any particular part of the plant.

The Circuit Court of Appeals held the petitioners' business to be unitary for the purpose of the application of the formula of subsection (g), on the authority of *Butler Brothers v. McColgan*, *supra*, a case in which the only question was the *constitutionality* of a statute prescribing the *measure* of the tax on a state franchise, the *taxability* of which was not even in issue. We believe the Court misconstrued the opinion in the *Butler Bros.* case but, be that as it may, it was improper for the Court to rule this state question on the authority of that decision; and, in so doing, it in effect rewrote the Oklahoma statute. It will be noted that under (g) a business is not unitary unless all factors of the enterprise are "essential to the realization of *an* ultimate gain derived from the enterprise as a whole." (Emphasis ours.) Under the Circuit Court of Appeals conception of unitary the quoted words should read "essential to *the* ultimate gain that is realized from the enterprise as a whole." Thus the Court obliterated the distinction, drawn so carefully by the legislators, between a unitary business and a merely interstate business.

II.

Subsection (g), Title 68, Oklahoma Statutes, 1941, as applied to the railroad's entire net income violates the Due Process Clause of the Fourteenth Amendment to the Federal Constitution in that the formula prescribed therein operates in such a way as to reach income not earned in Oklahoma.

It is axiomatic that a state may tax objects, persons or events only when they are located or happen within the territorial limits of the state. *Situs* is a decisive factor in defining state taxing power; and the barrier of the

Fourteenth Amendment protects all objects if their situs is outside of the state attempting to reach them. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U. S. 123; *Alpha Cement Company v. Massachusetts*, 268 U. S. 203; *Wallace v. Hines*, 253 U. S. 66; *International Paper Company v. Massachusetts*, 246 U. S. 135; *Connecticut General Life Insurance Company v. Johnson, State Treasurer*, 303 U. S. 77; *James, State Tax Commissioner v. Dravo Contracting Company*, 302 U. S. 134; *Standard Oil v. Thoresen*, 29 Fed. 2d 708; *Shaffer v. Carter*, 252 U. S. 37; *Curlee Clothing Co. v. Oklahoma Tax Commission*, 180 Okla. 116; 68 Pac. 2d 834.

A state may constitutionally impose a tax on the entire income of a resident because domicile itself affords basis for such taxation. However, as to a non-resident—such as the petitioners in this case—only that part of its income which is produced within the state may be taxed, the taxing power of the state in such a case being actually *in rem*. *Shaffer v. Carter*, *supra*.

The Circuit Court of Appeals said that (R. 257)

“Oklahoma does not seek to tax property beyond its borders. It seeks to reach only its fair share and proper proportion of a unit income of a unitary system operating within its borders, and the only question is whether the statutory method of allocation reasonably tends to bring this about.”

When a question is whether a tax imposed by a state deprives a party of rights secured by the Federal Constitution, the decision is not dependent upon the form in which the taxing scheme is cast; or what the state seeks to do; or how the taxpayer's business may be labeled. The controlling test is to be found in the operation and effect of the law as applied and enforced by the state. *Shaffer v. Carter*, *supra*.

What is to be found in the operation and effect of the formula of subsection (g) when applied to the business of this railroad? It is that a tax of 6 per cent is levied on net income derived from property located and transactions performed wholly outside Oklahoma and to the earning of which income Oklahoma property and operations contributed nothing. Taking 1941 as an example, the tax commission, by the use of the formula of (g), determined the railroad's Oklahoma taxable net income to be 10.62 per cent of its entire net income. The tax thereon was \$19,226.92 (Exhibit 14, R. 142) which amounts to approximately .6 per cent of net income earned everywhere. Just as surely as if it had been done directly instead of through the medium of a complicated formula Oklahoma laid a tax of .6 per cent on income derived from traffic moved from Memphis to Little Rock, from Minneapolis to Kansas City; from suburban service in Chicago; from rents of buildings and property located in Kansas; from switching in Missouri; from parcels checked in Iowa; and from many other transactions occurring in states other than Oklahoma.

"Whether the statutory method of allocation reasonably tends" to reach a "fair share and proper proportion" of the railroad's system net income is not "the only question", as asserted by the Circuit Court of Appeals (R. 257). It is not the question at all. Petitioners raise no issue as to the soundness of the formula of (g) as a formula for reaching a "fair share and proper proportion" of a net income which is in its entirety the joint product of processes geographically separated but each essential to the creation of that product. Petitioners do not, as did the taxpayer in *Maxwell v. Kent-Coffey Mfg. Co.*, 204 N. C. 365; 168 S. E. 397; affirmed *Kent-Coffey Mfg. Co.*

v. *Maxwell*, 291 U. S. 642, attempt to substitute for the statutory formula for apportioning entire net income a *better* formula for the same purpose. Petitioners' contention is that there is no place in this case for a formula which attributes to Oklahoma a fractional part of net income, whatever may be the intrinsic merits of the formula as a formula. Whether the net income Oklahoma arrogates to itself is a "fair share and proper proportion" of the entire net income is immaterial; whether it laid a tax on income not having its *situs* in Oklahoma is vital. Even if, by accident, 10.62 per cent of system net income for 1941 equalled exactly net income actually derived from property located and transactions occurring in Oklahoma the tax would be unconstitutional because levied on income not having its *situs* in Oklahoma. It is true that under the operation of the statutory formula only 10.62 per cent of Oklahoma net income was taxed; but, needless to say, if Oklahoma has taxed income earned out of the state it cannot justify such action by refraining from taxing to the full extent income earned within the state. If the railroad had carried an additional million tons of freight during 1941 between Rock Island, Illinois and Chicago, Illinois, and had gained thereby large additional revenue therefrom, what claim has Oklahoma to a share in the additional income? But, under the tax commission's method, Oklahoma taxable net income and the resulting tax thereon would have been larger. It is simple mathematics that as a system net income increases as a result of strictly non-Oklahoma transactions, the amount obtained by applying the average arithmetical ratio thereto becomes increasingly greater.

It is because of the nature of petitioners' business, of course, that the formula of (g) reaches an essentially arbitrary result. If petitioners were engaged in making, selling and renting typewriters, as was the taxpayer in

Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, with their factory in Oklahoma and their main outlet in Chicago; then, of course, Oklahoma would be entitled to its "fair share and proper proportion" of net profits received in Illinois because without the Oklahoma activity no net profits would be received in Illinois.

The Circuit Court of Appeals likened the case at bar to those cases which hold that businesses operating in interstate commerce have a unitary value which may be apportioned among the states for *ad valorem* tax purposes. The leading case on this proposition is *Adams Express Co. v. Ohio*, 165 U. S. 194, cited by the Court. All that is decided in that case is that the value of the Express Company's property consisting of its horses, wagons, safes, pouches, furniture, etc., was not the sum of the separate values of each item, considered as a distinct subject of taxation, but the value arising from the unity of use in the express business. We do not question the soundness of that or similar decisions, but what significance has that principle here where the tax is not on property, or measured by its value, but on income. Property is one thing; income is another. Value tends to distribute itself over the property as a whole but income can be attributed with a high degree of exactitude to the specific segments of the property which produce it. In the case at bar, the entire net income of the railroad is fixed and definite in amount; and the issue relates, not to the *value* of parts of that income, but to their *situs*. On the other hand, in *ad valorem* cases the *situs* of the object taxed is fixed and definite; and the issue relates to the *value* of that object.

The Circuit Court of Appeals also cites as authority for its decision on this federal question *Butler Bros. v. McColgan*, 315 U. S. 501. We respectfully submit that

that case differs from the instant case in two important respects:

(1) In the *Butler Bros.* case there was no dispute as to the state's right to tax the company's franchise, the issue being the reasonableness of the *measure* of the tax. In the instant case subsection (g) seeks to create, or to delineate, the taxable object itself; and if, in so doing, it includes income earned outside of Oklahoma, whether it be one dollar or a million, the assessment is unconstitutional. "The amount demanded is unimportant when there is no basis for the tax". *Alpha Portland Cement Co. v. Massachusetts*, 268 U. S. 203.

(2) The nature of the *Butler Bros.* business, upon which the decision turned, was fundamentally and materially different from that of petitioners. The very fountain-head of the *Butler Bros.*' profits was its central buying division, which was able to obtain, by reason of the volume of purchases, more favorable prices "than would be obtainable in respect of purchases for the account of any individual house."

We have cited as authority for reversal of the judgment of the Circuit Court of Appeals *Hans Rees' Sons, Inc. v. North Carolina*, 283 U. S. 123, and we believe that it is ample authority for the purpose. However, may we emphasize in this connection that the railroad's case herein is far stronger than that of the taxpayer in the *Rees'* case. In that case the *ratio decidendi* was that extra-territorial income had been taxed; and this Court held that the great disproportion between business transacted in North Carolina and income attributed to the state by its taxing authorities was sufficient evidence of that fact. In the instant case it appears directly, from the nature of petitioners' business, that extra-territorial income has been taxed and, hence, there is no occasion to

consider whether the "result" of the use of the statutory formula was "a fair share and proper proportion" of the railroad's net income.

The Circuit Court of Appeals, although conceding with respect to the tax commission's method that "mathematical exactness in allocating system value is impossible of attainment," pointed out "some of the errors in the methods used by the railroad in allocating" intrastate expense. We believe the bases of allocating expenses shown on Exhibit 6 (R. 73) are appropriate, and that by their application to the various items of expense "allocation to the segment of the system on which they occurred" is possible with reasonable clarity. These bases of allocation were not devised merely for the purpose of preparing the Oklahoma returns for the years 1941 and 1942; they have been used for more than 30 years and with respect to all states in which the railroad operates (R. 196); the Oklahoma Corporation Commission accepted the results of their use in 1941 and 1942; and the tax commission itself used "Railway Operating Expenses within the State" (Exhibits 4 and 4-A, R. 51 and 57) derived thereby as the antecedent terms in one of the ratios of their formula. However, petitioners do not undertake to demonstrate the perfection of each and every one of their bases of allocation. Perhaps qualified accountants would have different ideas about how to apportion certain items; but these considerations do not benefit the respondents. If the statutory formula operates unconstitutionally, it is not the railroad's duty "to propose methods which would bring about the desired permissible result" (R. 259). The subject matter of this action is the \$91,843.20 which petitioners paid in response to a demand. If respondent's method of arriving at the amount demanded and paid violates the Federal Constitution petitioners are entitled to recover. The tax commission's method cannot gain validity which it does not

otherwise have by reason of mistakes made by the petitioners. The direct allocation principle cannot be repudiated because of errors in its application. The remedy is to correct the errors; and the petitioners have stood throughout these proceedings, and still stand, ready and willing to correct them.

CONCLUSION.

Petitioners respectfully submit that the decision of the Circuit Court of Appeals for the Tenth Circuit is erroneous with respect to both the local question and the federal question, which are involved in this case; that these questions are of general importance in the administration of state income tax laws, and that it is in the public interest to have them determined by this Court.

Respectfully submitted,

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APPENDIX.

Subsection (a), Section 876 of Title 68, Oklahoma Statutes 1941:

“(a) A tax is hereby levied upon every person as defined in Section 874(b), which tax shall be collected and paid, for each taxable year, upon, and with respect to, the entire net income of such person, which is derived from all property owned and/or business transacted within this State. And a like tax is hereby levied upon every person as defined in Section 874 (b), which tax shall be collected and paid, for each taxable year, upon, and with respect to, the entire net income of such person which is derived from all property owned partly within and partly without this State and/or business done partly within and partly without this State (commonly known as interstate business), such income derived from property owned partly within and partly without this State and/or from business transacted partly within and partly without this State, upon which said tax is hereby levied, to be determined or allocated under the formula or formulae as provided in Section 878 of this Act. Every resident individual shall likewise be subject to the tax hereby levied upon the entire net income of such individual, derived from wages, salaries, commissions, professional or occupational earnings or other compensation received from personal services.”

Subsections (d), (e), (f), (g) and (h) of Section 878 of Title 68, Oklahoma Statutes 1941:

(d) The entire net income which is derived from all property owned and/or business transacted within this State and which is derived from all property owned partly within and partly without this State

and/or business transacted partly within and partly without this State shall be allocated or determined in accordance with succeeding subsections of this Section.

(e) Items of the following nature shall be allocated as indicated:

(1) Income from real and tangible personal property, such as rents, oil and mining production or royalties, and gains or losses from sales of such property, shall be allocated in accordance with the situs of such property;

(2) Income from intangible personal property, such as interest, dividends, patent or copyright royalties, and gains or losses from sales of such property, shall be allocated in accordance with the domiciliary situs of the taxpayer, except that

(3) Income from property, such as described in paragraph (2) of this subsection, which has acquired a business or commercial situs apart from the domicile of the taxpayer shall be allocated in accordance with such business or commercial situs;

(4) Allowable deductions attributable to items separately allocable in paragraphs (1), (2), and (3) of this subsection, whether or not such items of income were actually received, shall be allocated on the same basis as those items.

(f) Net income (or loss) from a business activity of substantial separateness and completeness, such as might be maintained as an independent business (however convenient and profitable it might be if operated conjointly with a related activity) and capable of producing a profit in and of itself, shall be separately allocated to the State in which such activity is conducted.

(g) It is intended that the net income (or loss) remaining after the separate allocations in subsections (e) and (f) *supra*, shall be only that which is derived from the conduct in more than one state of a single business enterprise (commonly called unitary business), all the factors of which enterprise are

essential to the realization of an ultimate gain derived from the enterprise as a whole, and not from its component parts which are too closely connected and necessary to each other to justify division or separate allocation in subsection (f) *supra*. The portion of such net income (or loss) remaining which represents the net income earned (or loss sustained) within this State shall be determined on the basis of the arithmetical average of the factors enumerated below in paragraphs (1), (2), and (3).

If the 'net income (or loss) remaining' referred to above is the sum of gains or losses, or is the remainder after reducing gains by losses (or vice versa), derived from two or more such single business enterprises, then separate determinations shall be made for each such enterprise on the basis above provided. The phrase 'antecedent term,' as used in this subsection means (according to the context) investment, expenditure, sales or other substituted factor, within Oklahoma.

(1) The ratio of the average accumulated investment at the beginning and close of the taxable year in tangible property, both real and personal, owned and used in Oklahoma by the taxpayer in connection with the enterprise, to the total of such investment in like property so owned and used by the taxpayer everywhere.

Property the income from which is separately allocated in subsections (e) or (f) *supra*, shall not be included in determining this ratio. The antecedent term of the ratio shall include a portion of the investment in transportation and other equipment having no fixed situs (such as rolling stock, busses, trucks, and trailers, including machinery and equipment carried thereon, airplanes, salesmen's automobiles, and other similar equipment) in the proportion that miles traveled in Oklahoma by such equipment bears to total miles traveled.

(2) The ratio of the expenditure in furtherance of the enterprise, for direct costs of operation within

Oklahoma to the total of such expenditures everywhere. The term 'direct costs of operation' shall be interpreted in accordance with the accepted accounting practice in the trade or business but shall not include the cost of goods and materials purchased for manufacturing, processing, assembling, or other similar purposes, or for resale, or interest, taxes, losses, bad debts, depreciation, depletion, amortization, contributions, general and administrative expenses, or expenditures separately allocated in subsections (e) or (f) *supra*.

In the case of a transportation enterprise the antecedent term of the ratio shall include a portion of such expenditure in connection with employees operating equipment over a fixed route (such as trainmen, airline pilots, or bus-drivers), in this State only a part of the time, in the proportion that mileage traveled in Oklahoma bears to total mileage traveled by such employees. In any case the antecedent term of the ratio shall include a portion of such expenditures in connection with itinerant employees (such as traveling salesmen) in this State only a part of the time, in the proportion that time spent in Oklahoma bears to total time spent in furtherance of the enterprise by such employees.

(3) The ratio of gross sales or gross revenue of the enterprise, excluding items separately allocated in subsections (e) or (f) *supra*, within Oklahoma to the total of such sales or revenue everywhere.

In the case of a manufacturing or mercantile enterprise, the antecedent term of the ratio shall include the gross amount of all sales whereby goods or materials are, by taxpayer, or pursuant to his direction, (A) delivered to purchaser at a point within this State; and (B) shipped to purchaser: (1) from a point within Oklahoma to any point except a point in another State where taxpayer is doing business; and (2) from a point outside this State to a point within this State; and, (3) on an order secured or received by an Oklahoma office or factory or branch

or by representatives residing or stationed within this State or working out of said office or factory or branch, from a point outside Oklahoma to a point in another State where taxpayer is not doing business.

In the case of a railroad or interurban railway enterprise, the antecedent term of the ratio shall not be less than the allocation of revenues to this State as shown in its Annual Report to the Oklahoma Corporation Commission. In the case of an airline, truck or bus enterprise, or freight car, tank car, refrigerator car, or other railroad equipment enterprise, the antecedent term of the ratio shall include a portion of revenue from interstate transportation in the proportion that interstate mileage traveled in Oklahoma bears to total interstate mileage traveled.

In the case of an oil, gasoline, or gas pipe line enterprise, the antecedent term of the ratio shall be the total of traffic units of the enterprise within Oklahoma, and the consequent term shall be the total of traffic units of the enterprise everywhere. A 'traffic unit' is hereby defined as the transportation for a distance of one mile, of one barrel of oil, or one gallon of gasoline, or one thousand cubic feet of natural or casinghead gas, as the case may be. In the case of a telephone or telegraph enterprise, the antecedent term of the ratio shall include a portion of interstate toll service revenues in the proportion that toll line wire miles within Oklahoma bears to the total of toll line wire miles. A 'toll line wire mile' is hereby defined as one mile of single wire used in the transmission of toll messages, exclusive of wire used for local exchange messages."

(h) In any case where use of the arithmetical average of three factors prescribed in subsection (g) *supra*, attributes to Oklahoma a portion of net income of the enterprise out of all appropriate proportion to the property owned and/or business transacted within this State, because of the fact that one or more of the factors so prescribed are not employed

to any appreciable extent in furtherance of the enterprise; or because one or more factors not so prescribed are employed to a considerable extent in furtherance of the enterprise; or because of other reasons, the Commission is empowered to permit, after a showing by taxpayer that an excessive portion of net income has been attributed to Oklahoma, or require, when in its judgment an insufficient portion of net income has been attributed to Oklahoma, the elimination, substitution, or use of additional factors, or reduction or increase in the weight of such prescribed factors.

Provided, however, that any such variance from such prescribed factors which has the effect of increasing the portion of net income attributable to Oklahoma must not be inherently arbitrary, and application of the recomputed final arithmetical average ratio to the net income of the enterprise must attribute to Oklahoma only a reasonable portion thereof.